9 August 2018

RBNZ Stridently Dovish

- The new regime reveals its spots
- Concerns over growth dominate rising inflation
- So RBNZ delays rate increase
- We still think inflation's coming
- But, as forewarned, push our first rate hike out to August 2019

The new regime has clearly revealed its spots with today's Monetary Policy Statement. The question going into it was would the Governor be more concerned about the weakening growth indicators or would he be more bothered by the upward trend in both core and headline inflation? The answer is now there for all to see – weak growth won the day. Inflation forecasts were, on balance, little changed but this was not enough to prevent the RBNZ lowering its interest rate track.

The MPS was openly dovish (when compared to the May MPS) whereas we had expected a slight nod to the hawkish side. As we are becoming accustomed to, the RBNZ's new-found transparency placed the message right up front "We expect to keep the OCR at this level through 2019 and into 2020, longer than we projected in our May Statement." Moreover, the Bank reintroduced the phrase "The direction of our next OCR move could be up or down" which was dropped in June.

With respect to the rising inflation that we are witnessing, the RBNZ not only dampens any concerns about it but openly welcomes the developments. The impact on the headline inflation rate from global oil prices, the lower exchange rate and petrol tax excise increases are largely dismissed as one offs. At the same time the Bank "welcomes early signs of core inflation rising".

The scenario analysis in the MPS also reveals the Bank's dovish biases. Under the Bank's higher inflation scenario it raises the cash rate by 50 basis points more than its central scenario. However, was growth to surprise on the downside, the door is open to a 100 basis point cut.

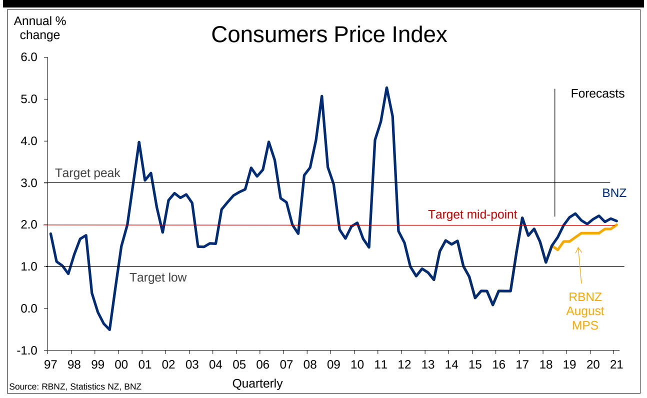
Ultimately, we think the Bank is going to get both of these outcomes – namely lower growth and higher inflation. However, the Bank has low-balled its near-term growth forecasts so any downside surprise is unlikely to show up until calendar 2019. Indeed, near term we see upside risks to both the Bank's growth and inflation forecasts. Consequently, we think there is little chance that the data will give markets the chance, near term, to price in a full 25 basis point cut.

Interestingly, the reduction in the Bank's near term growth forecasts have one-for-one been translated into an easing in capacity constraints. This implies the drop in the RBNZ's growth forecast is all been seen as demand driven and, hence, largely explains the comfort with inflationary pressures that the Bank has. We, on the other hand, think reductions in supply are, currently, as important in lowering growth as are demand issues. This being so you can still get lower growth accompanied by higher inflation as evidenced in current labour market pressures.

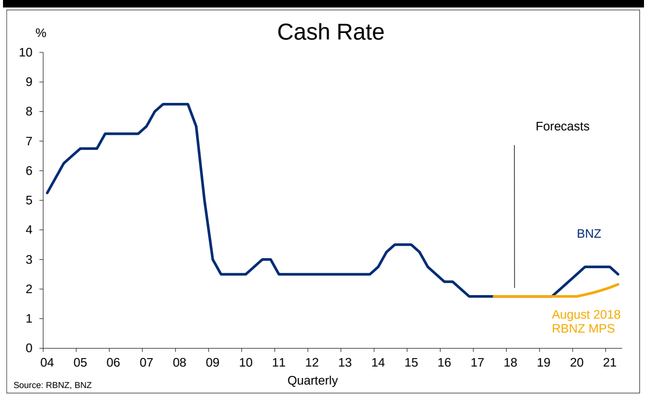
We think today's dovish tilt pushes the RBNZ towards a corner in a way that could have been avoided. After all, the Bank has raised its inflation forecasts, marginally, relative to May and its own rhetoric today will actually further add to inflation via the lower NZD that has inevitably ensued.

We stand by our view that inflationary pressures are building more than the RBNZ is expecting. We also believe that those pressures will remain longer-lasting

RBNZ Underestimating Inflation?



So Rates Higher?



National Australia Bank

than the Bank anticipates. And last but not least, we think the Bank needs to contemplate normalizing interest rates as soon as it gets the opportunity. Indeed, the very reason why the Bank has interest rates still rising in its forward published track is because it acknowledges that the cash rate is currently below neutral.

Whatever the truth of the matter, we can't ignore what the RBNZ is telling us and, to be fair, at least the messaging is relatively clear.

We have been warning for some time that we might need to delay our first rate hike prediction so we are, today, taking the opportunity to formally push back our forecast first rate hike to August 2019 from May 2019. We have also lowered the peak in our interest rate track to 2.75% from 3.00%.

We believe you either have to forecast interest rate hikes relatively early or not at all. If the Bank hasn't raised rates by late 2019 then it is highly likely that we will be looking at an economy that is by then at the completion of the current economic cycle. Hence, slowing growth at that stage will result in falling inflationary pressures and no need to raise rates at all. Was this to pan out then rates could well stay exactly where they are (or lower) for a very long time indeed.

Not surprisingly fixed interest rate markets rallied on the back of today's announcement and the NZD fell. The market is trying to price in a genuine chance of an easing but barring any shock we don't think it will get the chance to push on with this. The first tightening is now priced for May 2020.

While not consistent with our view, it is understandable why the market would move in this direction. What is perhaps more surprising is that the yield curve has flattened with the two year swap rallying six points and the five year nine - surprising because today's actions imply higher, not lower, future inflation.

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The full text of today's RBNZ OCR Review – Official Cash Rate unchanged at 1.75 percent

Statement by Reserve Bank Governor Adrian Orr:

Tena koutou katoa, welcome all.

The Official Cash Rate (OCR) remains at 1.75 percent. We expect to keep the OCR at this level through 2019 and into 2020, longer than we projected in our May Statement. The direction of our next OCR move could be up or down.

While recent economic growth has moderated, we expect it to pick up pace over the rest of this year and be maintained through 2019.

Robust global growth and a lower New Zealand dollar exchange rate will support export earnings. At home, capacity and labour constraints promote business investment, supported by low interest rates. Government spending and investment is also set to rise, while residential construction and household spending remain solid.

The labour market has tightened over the past year and employment is roughly around its maximum sustainable level. We expect the unemployment rate to decline modestly from its current level.

There are welcome early signs of core inflation rising. Inflation will increase towards 2 percent over the projection period as capacity pressures bite. This path may be bumpy however, with one-off price changes from global oil prices, a lower exchange rate, and announced petrol excise tax rises expected. We will look through this volatility as appropriate, and only respond to any persistent movements in inflation.

Risks remain to our central forecast. The recent moderation in growth could last longer. Low business confidence can affect employment and investment decisions. Conversely, there is a chance that inflation could increase faster if cost pressures can pass through into higher prices and impact inflation expectations.

We will keep the OCR at an expansionary level for a considerable period to contribute to maximising sustainable employment, and maintaining low and stable inflation.

Meitaki, thanks.

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